

Internal Revenue Service
memorandum

CC:INTL-379-90

Br5:TBHughes

date:

DEC 20 1990

to:

P.J. O'Donnell, International Examiner, Pittsburgh District

from:

Chief, Branch 5, Office of Associate Chief Counsel
(International)

subject:

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You requested our assistance regarding various foreign tax credit issues in connection with the following facts:

██████████ owns █████ percent of a Brazilian corporation (S1), which owns █████ percent of a second tier Brazilian subsidiary (S2). The remaining █████ percent of S2 is owned by an unrelated Brazilian corporation. In tax years ending █████ and █████, S2 paid dividends to S1 and withheld a 15 percent tax on each payment, as required under Brazilian tax law. Later, and unrelated to the dividends it received from S2, S1 made a distribution to █████ out of income previously taxed under section 951¹ (PTI). S1 was required under Brazilian tax law to withhold a 25 percent tax; however, the amount of the tax was reduced by the amount of the 15 percent tax withheld on the dividends received from S2. The reduction totally eliminated the 25 percent tax on the distribution from S1 to █████.

█████ claimed a credit for the full amount of the 25 percent tax despite the fact that █████'s liability for that tax was reduced to zero because of the offset. █████ converted the S1 distribution into dollars at the exchange rate on the date the distribution was paid and converted the 25 percent tax at the rate of exchange in effect on the earlier date when S2 paid a dividend to S1. Because of the substantial depreciation of the cruzeiro, the earlier conversion date produced a larger dollar credit than

¹ All section references are to the Internal Revenue Code of 1954.

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would have resulted if █████ had used the exchange rate on the date when the liability for the 25 percent tax allegedly arose.

You asked us: (1) whether █████ is entitled to credit under section 901 any portion of either the 25 percent tax or the 15 percent tax; and (2) if yes, what exchange rate(s) should apply to convert the amounts of creditable taxes into dollars. For purposes of this memorandum, it is assumed that the taxes involved are creditable taxes.²

Subject to the limitation of section 904, █████ may choose to credit its U.S. taxes with the amount of any foreign income taxes paid or accrued during the taxable year, plus the taxes deemed to have been paid under section 902 and section 960. Where a U.S. shareholder, such as █████, of a CFC receives a distribution of PTI, the numerator of the section 902 fraction equals the amount distributed minus the amount of distribution that is PTI. Section 1.960-2(c). This prevents the shareholder from taking a double credit for taxes previously credited under section 960 on the PTI, i.e., on the previous Subpart F inclusions. Thus, because the distribution to █████ consisted entirely of PTI, the

²Cindy Mattson, a Special Trial Attorney in International, travelled to Brazil in early December and consulted with Brazilian tax experts to obtain further details on the dividend withholding taxes that could bear on the creditability of these taxes. You can call her at (FTS) 287-4851 after December 18 to discuss the results of her consultations. In addition, this case raises the issue of the █████'s legal liability for the withholding tax on dividends. To claim a credit under § 901, the U.S. taxpayer must be legally liable for the foreign withholding tax. Biddle v. Commissioner, 302 U.S. 573 (1938). In Continental Illinois Corporation v. Commissioner, T.C.M. (CCH) 1988-318, we argued that the U.S. recipient of interest subject to the Brazilian withholding tax was not legally liable for the tax. Although the Tax Court did not agree, we have not acquiesced. In Continental Illinois, expert testimony showed that the U.S. recipient of dividends subject to the Brazilian withholding tax also is not legally liable for the tax. Therefore, technically all credits applicable to the withholding tax on dividends could be disallowed. However, in response to similar inquiries, we suggested that the credits for dividends subject to the withholding tax be allowed (if otherwise allowable) until litigation involving the creditability of the withholding tax on interest is successful.

numerator of the section 902 fraction is zero, resulting in a deemed paid credit with respect to the distribution of zero.³

Because [REDACTED]'s liability for the 25 percent tax on the distribution from S1 to [REDACTED] was eliminated by the offset of the 15 percent tax, the 25 percent tax was not "paid...during the taxable year to any foreign country." Section 901(b)(1). Therefore, no portion of the 25 percent tax is paid or accrued under section 901.⁴ Further, it appears to us that, if S2 had failed to withhold the 15 percent tax on the dividend to S1, [REDACTED] would have had no legal liability for the 15 percent tax. Thus, [REDACTED] cannot claim a section 901 credit for the 15 percent tax.

Should you have any questions, please call Terry Hughes at FTS 566-6284.

cc: Christine Halphen
Rick Gannon
Cindy Mattson
John Lyons
Phyllis Marcus
Bill Lundeen
John Dean
Laura Apelbaum

³ When the PTI is exhausted, the 15 percent tax may become creditable. There is currently a project in-house to determine how to translate the multiplicand of the section 902 fraction where the taxes are stated in reference to so-called ORTN's. Please call Bill Lundeen at (FTS) 566-6645 for details.

⁴ Had the 15 percent tax been less than the 25 percent tax, the balance of the 25 percent tax (assuming it is a creditable tax) owed by [REDACTED] would have been creditable under section 901 and the excess limitation, if any, would have been computed under section 960. The creditable portion would have been translated from cruzeiros to dollars at the rate of exchange on the date of payment of the tax. Rev. Rul. 73-491, 1973-2 C.B. 267.